No. 17,352

IN THE

United States Court of Appeals
For the Ninth Circuit

FARMERS UNION CORPORATION, *Petitioner,*	
vs.	
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR PETITIONER

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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JURISDICTIONAL STATEMENT

This is a petition to review a decision of the Tax Court of the United States.

The petitioner is a corporation, organized under the laws of the State of California, on May 19, 1874. Its only business location is at 151 West Santa Clara Street, San Jose, California. The income tax returns involved in the subject controversy (calendar years 1951, 1952 and 1953) were filed with the District Director of Internal Revenue for the First District of California, at San Francisco, California. The hearing before the Tax Court of the United States was held

in San Francisco on October 7, and October 14, 1958. The proceedings were held pursuant to a statutory (90 day) letter, issued June 20, 1957, by the Commissioner of Internal Revenue for the Revenue District that includes the State of California (R. 3), a petition for redetermination of the alleged income tax deficiencies was filed with the Tax Court of the United States on September 3, 1957 (R. 5-8), and was answered by the Commissioner of Internal Revenue on October 16, 1957. (R. 8-9.) An Amendment to the Answer of the Commissioner was filed September 16, 1958 and petitioner's Reply to Amendment to Answer was filed at trial October 7, 1958. (R. 10-11.)

The Tax Court Memorandum (1960-179) containing its findings of fact and opinion was filed August 31, 1960 (R. 4, 254) and the Decision under Rule 50 of the Court was entered October 25, 1960. (R. 299.) The petition for review was filed January 19, 1961. (R. 300-302.)

The Tax Court of the United States had jurisdiction under 26 U.S.C. 7442. The United States Court of Appeals for the Ninth Circuit has jurisdiction under 26 U.S.C. 7482, 7483 (Internal Revenue Code of 1954, Section 7482).

STATEMENT OF THE CASE

This case involves income tax deficiencies alleged by the Commissioner of Internal Revenue and determined by the Tax Court to be in the amounts of $22,309.36 for 1951; $4,800.95 for 1952; and $7,647.91 for 1953 (calendar years).

The controversy as to all three years emanated from a loss incurred by petitioner, on June 30, 1951, when it transferred the inventory and related assets constituting its retail hardware business to seven stockholders in exchange for 8,000 shares of the 20,000 outstanding shares of its capital stock. Subsequent to this transaction these stockholders formed a partnership. Petitioner reported this loss in its income tax return for 1951 by including the agreed market value of stock received in the exchange as gross sales and noting the closing inventory as zero. The cost of goods sold thereby exceeded the gross sales by $217,527.20. (R. 275.) Respondent disallowed the reported loss and recomputed petitioner's income, after adding the cost of the inventory exchanged for stock to gross income. This disallowance was based upon respondent's contention that the transfer of corporation property for its capital stock was not a taxable exchange but a non-taxable distribution in partial liquidation.

The alleged income tax deficiencies for 1952 and 1953 are based on (1) respondent's disallowance of a carryover of a portion of the loss reported in 1951 to offset income of petitioner in the succeeding years, and (2) disallowance by respondent of deductions claimed by petitioner for accounting, legal and escrow expenses incurred and paid in connection with the exchange transaction described herein.

The issues are:

A. Whether the transfer by petitioner of its mercantile inventory and related assets and liabilities in exchange for 8,000 shares of its outstanding capital

stock was a taxable transaction or a non-taxable distribution of corporate assets in kind in partial liquidation.

B. Whether the loss sustained by petitioner in the exchange of corporation property for stock was a net operating loss, the unused portion of which was available to offset income in the five years succeeding 1951 or just a "non-business" loss that must be confined to that year for tax purposes.

C. Whether the legal, accounting and escrow expenses incurred and paid by petitioner in the subject transaction were deductible business expenses or capital expenditures of the new partnership entity that was formed by the stockholders who acquired the mercantile inventory from petitioner.

SPECIFICATION OF ERRORS RELIED ON BY PETITIONER

1. The Tax Court erred in holding that the transfer of corporation property in exchange for capital stock of the transferor (petitioner) was a distribution in partial liquidation in which no gain or loss may be recognized for income tax purposes.

2. The Tax Court erred in holding that if it be assumed, arguendo, the aforesaid transaction was a sale, the loss resulting therefrom would not be a carryover net operating loss.

3. The Tax Court erred in holding that the legal, accounting and escrow expenses were non-deductible capital expenses.

FIRST SPECIFICATION OF ERROR—FINDINGS OF THE TAX COURT AND OBJECTIONS THERETO.

No objection will be interposed as to the accuracy of the Findings of Fact, other than those stated under the heading "Ultimate Findings of Fact". (R. 279.) The portions of the Transcript of Record hereinafter noted and quoted are intended to supply omissions of fact that are considered significant and to clarify some inconsistencies.

(A) With reference to the efforts of petitioner to sell corporation assets, consisting of inventory and related items, prior to 1951, the Tax Court found as follows (R. 260-261):

> "Prior to 1951, the directors of the petitioner paid a good deal of attention to a continuing problem of high inventories in the mercantile business which reflected a slowing down of sales of certain items. From time to time certain types of merchandise which were not selling quickly or profitably were discontinued. The directors instructed the manager of the store to increase his efforts to sell larger quantities of merchandise and to reduce inventories of unprofitable lines of goods. In about 1945 and thereafter, petitioner's president gave consideration to the possibility of selling petitioner's mercantile business but petitioner never received and its directors never considered any specific offer of anyone to purchase the business."

(a) The testimony of John P. McEnery, President of petitioner-corporation, was as follows:

After testimony concerning a plan to divide the corporation into two corporations (R. 66):

"Q. What was your next plan?

A. The next plan was to approach it from the idea of selling the business.

Q. To whom?

A. To any buyer, anybody that would buy it, or selling the real estate, too. We had discussed that, selling the whole thing, to get out of it.

Q. Were any efforts made in that direction during the year 1951?

A. Yes sir, it was. There were.

Q. Could you say or estimate on the basis of your own recollection the number of attempts that you personally made to interest others in buying the retail business, that is, the inventory and other related assets that represented that business?

A. I talked to any reputable firm, both in San Francisco and San Jose, many of them that I knew.

Q. Could you name a few?

A. Yes. A Mr. Gunn, who is now in business in San Jose, who was then with Coldwell & Banker Company; Clayton & Company, the biggest real estate office in San Jose; the manager of Blythe & Company in the Bank of America, San Jose, Mr. Paul Muth; a gentleman by the name of Crist in Los Gatos came to us—it is in the minutes here someplace—and offered us, wanted to get an exclusive on the sale of the real estate alone."

Later, Mr. McEnery on direct and cross-examination (R. 204 to 209):

"Q. (By Mr. Yeo) In connection with your previous testimony, Mr. McEnery, concerning your efforts to sell the retail hardware business

prior to 1951, I believe you testified that you had made a number of attempts to sell this business, either wholly or in segments, that were unsuccessful.

Mr. Yeo. Would you mark this for identification?

The Court. 31 for identification.

(Petitioner's Exhibit No. 31 was marked for identification.)

Q. (By Mr. Yeo). I will show you Petitioner's Exhibit 31 for identification and ask you to identify it.

A. That is a letter that I received from Blythe & Company, a Mr. Paul Muth.

Q. Would you state briefly the substance of that letter?

A. On December the 27th, 1950—I might as well read it, it is short—'There appeared an article in the Mercury to the effect that a new corporation was being formed to separate the business of The Farmers Union Store from the real estate property and that the new corporation would operate solely in the hardware business. Since seeing the article in the paper, I have been wondering whether there is any chance that some time in the future the controlling factors in the corporation might be interested in selling out the hardware business. I feel very sure that if you would consider selling, Blythe & Company would be able to get you a very attractive offer. I would appreciate very much if you would put this letter on file and remember to give us an opportunity to obtain a purchaser if you consider selling.

'(Signed) Paul Muth.'

This letter was written January 2nd, 1951.

Q. Was any action taken by you or any representative of The Farmers Union Corporation in response to this letter?

A. Many conferences were held with Mr. Muth in San Jose, and a meeting was held in San Francisco with Blythe & Company.

Q. Did you receive any other letters or correspondence of the same character during the period of 1949 to 1951, inclusive?

A. I received many letters.

Q. Do you have any other letters of a similar character?

A. Well, Mr. Yeo——

Mr. Munter. Just answer the question, please.

The Witness. What was the question?

The Court. Read it.

(Last question read.)

Q. (By Mr. Yeo) I said: 'Did you receive any other letters of a similar character?'

A. Yes.

Q. Do you have any such letters or copies of such correspondence available to you now?

A. No, I have not.

Q. Why not?

A. Because in 1952 we had an employee who was office manager, Mr. Gallagher, go sour on us, and shortly before he committed suicide here in San Francisco by jumping off the Bridge, he set the records of the store, practically boxes and boxes of records, on fire; he put them in the incinerator and burned them. Among those was the correspondence that I had stored in the warehouse in a file. The letters that I was able to find, the only letters that I was able to find, were the letters that I had in my own possession, in my personal file, either at home or in my office at my home. It is impossible to find any more,

but I am sure that the record could be more complete by bringing in other witnesses, such as Clayton & Company, which I had signed an exclusive agreement with at one time to sell the business and the building——

Mr. Munter. I believe we are exceeding the scope of the question and the interest——

The Court. Go ahead. The objection is overruled. Continue.

A. (Continuing) Blythe & Company, Clayton & Company, Coldwell & Banker Company, the man that I mentioned in Los Gatos—I mentioned it the other day, I can't even think of it now, an older gentleman who has a very prominent real estate office there. At Coldwell & Banker, I dealt with a Mr. McCulloch, who is still there, in San Francisco, and on a number of occasions I dealt with Mr. Phair in Los Angeles who is with Coldwell & Banker in Los Angeles. And they had tried to interest any number of people in the purchase of the whole Farmers Union setup.

Q. (By Mr. Yeo) And all of this occurred prior to 1951?

A. Yes.

Q. And that is your clear recollection?

A. Yes. I have a clear recollection of it, yes, I have.

Mr. Yeo. That is all. You may cross-examine.

The Court. That wasn't offered, but I suppose you ought to offer it.

Is there any objection to 31?

Mr. Munter. We have no objection to 31, your Honor.

The Court. 31 is received in evidence.

(Petitioner's Exhibit 31 was received in evidence.)

The Court. Now you may inquire.

Cross-Examination

By Mr. Munter:

Q. What was the time that you were having these conversations with Mr. McCulloch and Mr. Phair? Was this in 1951?

A. I would say that it ran from, anywhere from 1947 or '48 up to '51. In fact, we are still having conversations with him, we are in the act of discussing, we couldn't make a sale so now we are discussing trades.

Q. After you got this letter, Exhibit 31 in evidence, did you then have additional conversations with Mr. Muth?

A. Yes, and a number of letters where we signed up with Blythe & Company.

Q. Didn't he say in this letter that he could get you a very attractive offer? Isn't that what the contents of this letter are?

A. Yes. And he never did.

Q. Just answer the question, please.

A. Yes, sir.

Q. Now, after this letter was written, in which Mr. Muth stated he could find you an attractive offer, that he could find you attractive offers you proceeded with your plan to divide the corporation into two separate corporations, isn't that correct?

A. No, sir.

Q. Isn't it correct, didn't the directors make a resolution and the stockholders make a resolution directing the directors to divide the corporation into two corporations, after the date of this letter?

A. Yes, after the date of the letter. Six months afterwards, five months afterwards."

Mr. Louis A. Rossi, Director and former general manager of petitioner, testified as follows (R. 219 to 221):

"Mr. Yeo. I interrupt, Mr. Rossi, in order to conserve the time of the Court and request that you confine your review of the situation to those matters bearing upon the final decision of the corporation to transfer the retail hardware business to the stockholders.

The Witness. Yes, I will.

A. (Continuing.) Shortly after the close of the war, The Farmers Union Corporation was showing losses in its business, there was quite a bit of pressure brought to bear on the directors on the part of the stockholders, both small and large, to sell the retail end of the business. Mr. McEnery attempted to buy the retail end of the business. The directors thought it was only fair that the stock be offered for sale to the stockholders. Every stockholder was given an opportunity to purchase the stock. In fact, Mr. Benson, it is a matter of record that he indicated that he would step aside and let the stockholders buy whatever they wanted of the 8,000 shares, and that he would take the balance.

Q. To your recollection, did the board of directors ever discuss or consider the possibility of selling the merchandise representing the retail business in segments or in, by departments, in an attempt to eliminate the inventory ultimately?

A. Yes, they have discussed that on many, many occasions. In fact, we even went so far as to discuss the liquidation of the inventory by either sale in small portions or by sale under auction.

Q. What was your conclusion on that?

A. My conclusion was that if we had sold the inventory, amounting to $284,138.79, and the fixtures and trucks and accounts receivable, that the corporation would have suffered a loss of approximately $200,000.00.

The Court. What do you mean by that? What do you mean by 'if we had sold'?

The Witness. For the reason that——

The Court. Wait a minute.

The Witness. Excuse me.

The Court. There is a big 'if' there. You say 'if we had sold'.

The Witness. Your Honor——

The Court. If you had sold to whom?

The Witness. If we had sold by liquidation to the public through auction, in a forced sale, the most we could have received would have been about 50 cents on a dollar, the corporation would have suffered a loss of approximately $200,000.00.

Q. (By Mr. Yeo.) That estimate of yours, Mr. Rossi, of a loss of $200,000.00, is it based merely on estimates, or did you have pending offers or discussions in proposals of purchase of these corporate assets?

A. It is based on 25 years of experience in the retail merchandising management.

Q. Were there any discussions in your presence with people——

The Court. He has answered your question now. He says that is his estimate based on his own experience.

Q. (By Mr. Yeo.) This represents your own personal estimate?

A. Yes.

Q. Did you present this estimate to the board of directors?

A. We discussed it at a board of directors' meeting."

On re-direct examination of Mr. Rossi (R. 246 and 247):

"Q. (By Mr. Yeo.) You attended all of the board of directors' meetings in the year 1951?

A. Yes, sir, I did.

Q. And you testified on cross-examination that during the course of these meetings you did not learn of any specific offer that was made to buy the merchandise of the corporation, is that true?

A. That is correct, sir.

Q. During the course of these meetings of the board of directors, did you learn or did you receive any reports of representatives of the corporation who had conversations on the subject of a possible sale or a transfer of the merchandise representing the inventory?

A. Reports of discussions, yes. But nothing specific.

Q. So you knew of your own knowledge that, then, negotiations had actually been conducted along the line of possible sale or exchange of the merchandise representing the inventory of the corporation.

Mr. Munter. I will object to that as a conclusion, as calling for a conclusion——

The Court. The objection is sustained. And the objection is sustained for this reason: This witness was one of several directors. He attended some meetings. The reports that were made have not been identified, and his answer is

too much in the nature of hearsay for me to be able to give any weight to it.

Mr. Yeo. I will strike the question, withdraw the question.

The Court. Reframe your question.

Q. (By Mr. Yeo.) In the course of the board of directors' meetings did you hear, yourself, of any reports directed to the board of directors bearing on the subject of negotiations for the sale of the corporation property?

A. Yes, sir, I did.

Q. How many times did you hear that during the year 1951?

The Court. Who made these—excuse me, please—who made such reports to the board of directors?

The Witness. Mr. McEnery reported at every monthly meeting on his various discussions with prospective buyers. But none were interested in buying the assets of the business.

Mr. Munter. I will object to that. This is mere hearsay, as to what the buyers did or did not do. Mr. McEnery is——

The Court. The objection is overruled.

A. To the best of my knowledge——

The Court. You have answered the question.

Mr. Yeo. Don't volunteer anything."

(b) Concerning petitioner's plan to exchange corporate assets for stock, the Tax Court found as follows (R. 267 and 268):

"The plan of petitioner's directors for the 'division and segregation' of the operation of the real properties of petitioner from the ownership and operation of the merchandising business of

petitioner which was approved and adopted by the stockholders on June 7, 1951, listed the categories of assets which were primarily used in the merchandising business (such as accounts receivable, merchandise inventory, autos and trucks, furniture and fixtures, and prepaid items) which were to be transferred to stockholders in exchange for 8,000 shares of stock, and the plan also listed the types of liabilities which the transferees were to agree to assume, but nowhere in the plan was there stated the value of all or any item of the assets to be transferred or the amount of any liability which was to be assumed except that a note of petitioner payable to the Bank of America in the amount of $70,000 was stated as a specific liability to be assumed. In other words, no total value of the assets to be transferred and no total amount of the liabilities to be assumed by the transferees in exchange for 8,000 shares of stock was stated in the plan. The plan provided only that, in general, all of the assets used in the merchandising (hardware) business, subject to liabilities, were to be transferred to those who surrendered 8,000 shares of stock, and that for each share of stock surrendered each person entering into the transaction would receive a one/eight-thousandths interest in the transferred assets."

This finding is inconsistent with a preceding fact wherein determination of the value of the assets offered by petitioner was clearly set forth by the Tax Court, as follows (R. 264):

"The plan required that stockholders make their decision not later than June 14, 1951.

> There was attached to the notice to the stockholders of the special meeting a balance sheet showing the assets which were to be transferred in exchange for stock and the assets to be retained by petitioner if the stockholders approved the plan. Petitioner's accountant prepared the statement from petitioner's books. He was told that the plan was to sell the mercantile business assets and he used that word in the statement. The stockholders were accordingly advised about which assets might be exchanged for stock. The dollar amounts in the statement were the amounts at which the assets and liabilities were carried on petitioner's books, i.e., cost or cost less depreciation. The statement sent to the stockholders prior to June 7, 1951, was substantially the same as the statement set forth below which was prepared by the accountant in July, as of June 30, 1951."

Following the above finding, the Tax Court set forth a replica of the financial statement reflecting the identity and the valuation of the assets and liabilities "To be Sold" and "To be Retained", in conformance with the plan submitted to the stockholders. (R. 265; Exhibit 22.)

In connection with the preparation of the above mentioned financial statement, the following is the testimony of T. D. Caldwell, accountant for petitioner (R. 133 to 139):

> "Q. In connection with the assets that were proposed to be transferred by the corporation to those stockholders who would be willing to exchange shares of capital stock, I will ask you

whether in connection with that you had occasion to examine the books and records to determine the costs of the items to be transferred.

A. I did.

Q. And you made an original examination of all the books and records of the corporation in order to determine, in order to obtain that information?

A. That is correct.

Q. Did you have any instructions with reference to the date on which the evaluation would be computed in order to determine the tax effect upon the corporation and the individual stockholders involved?

A. I don't quite follow your question, Mr. Yeo.

Q. Did you receive any instructions as to the date on which the evaluation would be made of the assets to be transferred?

A. I think that I was informed by the board of directors of the corporation that they were going to try to get the partnership or whatever entity they entered into by the 1st of July, and that they would like to have a balance sheet and statement, profit and loss statement, and so forth, as of June 30th.

Q. Because of those instructions, did you thereupon prepare a balance sheet and a summary of the information that they required?

A. I did.

Q. I will show you a balance sheet on which are listed assets and liabilities and, over at the right, in separate columns, assets to remain in the corporation and assets to be sold, and ask you if you prepared that balance sheet?

A. I did.

Q. Did you prepare that from the original books and records of the corporation?

A. I did."

After Mr. Caldwell identified the various items set forth in the financial statement, he testified further, as follows (R. 137 to 139):

"Q. I will show you this duplicate, or this balance sheet here, and ask you if that is a photograph of your original balance sheet?

A. It is.

Mr. Yeo. I will offer this balance sheet in evidence, if your Honor please.

(Testimony of T. D. Caldwell.)

Mr. Munter. We are going to object to the characterizations of the transactions that appear on here. He has 'Assets to be Sold,' and that is——

Mr. Yeo. They were segregated for the purpose of making them available for transfer to persons to whom they would be sold.

Mr. Munter. That is assets to be exchanged in redemption of stock; to characterize it as a sale is disposing of the whole problem here.

Mr. Yeo. This is the way the document was originally prepared. I have no authority to change what was originally written.

Mr. Munter. The characterization that the accountant gave to the transaction is obviously of no value here, to the extent that if he had no knowledge of the transaction at all——

Mr. Yeo. Well, I am offering this in evidence for whatever value it may have if your Honor please.

The Court. Who told you to use these designations, like 'To be sold,' and so forth?

The Witness. That was, your Honor, I met with the board on a great many occasions, and particularly during this period when they were thinking of trying to sell——

The Court. Just be brief about it. You were told by members of the board, were you?

The Witness. No. That was the term that they were using during all of the conversations.

The Court. Well, that would boil down to the same thing. You were told by members of the board to make a segregation?

The Witness. That is correct.

The Court. Is that it?

The Witness. Yes.

The Court. The Respondent has stated his objection and the exhibit is received for what it is worth as Exhibit 21—is that the next number?

The Clerk. This has not been marked, your Honor, so the next number would be Exhibit 22.

The Court. Exhibit 22."

SECOND AND THIRD SPECIFICATIONS OF ERROR.

Petitioner believes that the right to carry over the net loss of the corporation in 1951, to succeeding years and the right to deduct expenses incident to the transaction here in controversy, are questions of law and procedure and that such rights should be established, as a matter of law, in favor of petitioner.

ARGUMENT

FIRST SPECIFICATION OF ERROR—THE TAX COURT ERRED IN HOLDING THAT THE TRANSFER OF CORPORATION PROPERTY IN EXCHANGE FOR CAPITAL STOCK OF THE TRANSFEROR (PETITIONER) WAS A DISTRIBUTION IN PARTIAL LIQUIDATION IN WHICH NO GAIN OR LOSS MAY BE RECOGNIZED FOR INCOME TAX PURPOSES.

The Findings of Fact by the Tax Court, except the Ultimate Findings of Fact (R. 256-278), as supplemented by portions of the record, quoted above, and by stipulation (R. 11-14), disclose a pattern of events from which this controversy developed, as follows:

1. At the beginning of taxable year 1951, petitioner owned and leased real property, in addition to owning and operating a retail hardware store, in San Jose, California. (R. 258.)

2. During the several years immediately preceding 1951, petitioner had also engaged in the business of retail sales of tires and auto accessories, groceries, meats and household wares. (R. 229 and 258.)

3. Prior to 1951, all the retail business activities of petitioner, except hardware, garden tools and related merchandise, had been terminated by liquidating sales to the public. (R. 51-52; 229-230.)

4. From 1948 to 1950, increasing dissatisfaction with the retail hardware business caused petitioner's Board of Directors to give consideration to the following described successive remedial plans, the first three of which were rejected, to-wit:

(a) Reduction of inventories and improvement of merchandising techniques. (R. 55-58; Exhibits 6, 7, 8 and 9.)

(b) Formation of another corporation and a subsequent exchange of petitioner's inventory and fixtures for stock, in a plan of reorganization. (R. 59-65; Exhibits 10, 11, 12 and 13.)

(c) Sale of the hardware business, as such, or liquidation of the assets by public sale or auction. (R. 204-207; 219 and 220.)

(d) Transfer of the business inventory, together with related assets and liabilities, in exchange for 8,000 shares of petitioner's outstanding capital stock and a 20-year lease of the store space by the transferees at the rate of $18,000.00 per year. (R. 69-81, 221-225; Exhibits 2-B, 3-C, 14, 15 and 16.)

5. Pursuant to adoption of plan (d), above, seven stockholders surrendered 8,000 shares of petitioner's capital stock in exchange for a proportionate undivided interest in the corporate assets offered. (R. 82-87; 198-199; Exhibit 30.)

6. The aforesaid seven stockholders thereafter formed a partnership which was later reduced to three partners. (R. 87-90; 269-271; Exhibits 4-D, 17.)

7. Coincident with the formation of said partnership, petitioner executed and delivered a Bill of Sale conveying the assets and liabilities described, in Exhibit 22 and R. 265, to the partners. (R. 169-170; Exhibit 5-E.) Petitioner received in exchange therefor the 8,000 shares of its capital stock and a lease by the partnership of the premises in which the hardware

business was located, covering a period of 20 years at $18,000 per year rental. (R. 79; 124-126; 221; 272.)

8. Subsequent to the transfer of corporation property for stock and the lease, petitioner reduced its stated capital from 20,000 shares to 12,000 shares, by resolution of its Board of Directors, dated August 16, 1951 (Exhibit 18) and ratification thereof by the corporation's stockholders, on February 13, 1952. (Exhibit 19; R. 91-94; 230-232; 273.)

The Tax Court held this transaction to be a distribution of the assets of the petitioner "in partial liquidation in redemption of the surrendered stock, and that there was not a sale of the assets for stock. The facts of the transaction bring it within Sections 115(c)[1] and 115(i),[2] Section 29.22(a)-20, Regulation 111[3] applies." (R. 291)

NOTE: All statutory references herein are to the Internal Revenue Code of 1939 and the Regulations pertaining thereto.

[1]*Section 115—Distributions by Corporations*

(c) *Distributions in Liquidation*

"Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock." The remainder of this section applicable in determining whether such distributions are out of capital or earnings.

[2]*Section 115—Distributions by Corporations*

(i) *Definition of Partial Liquidation*

"As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

[3]*Section 29.22(a)-20, Regulation 111—Gross Income of Corporation in Liquidation*

"When a corporation is dissolved, . . . Any sales of property by them are to be treated as if made by the corporation for

It may be observed that Section 115(c) is clearly inapplicable to the "facts of the transaction". A reading of that section and its corresponding Regulation (29.115-3) will disclose that the substance thereof is directed exclusively to the income tax responsibilities of *stockholders* who receive distributions from corporations in the process of liquidation. Neither the statute nor the Regulation have any bearing upon the determination of the income tax liabilities of the liquidating corporation. Furthermore, in order to make the "facts of the transaction" susceptible to judicial consideration, in the light of all of applicable law, Section 29.22(a)-15 of Regulation 111 should be included.[4] This particular Regulation contains the

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the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition."

[4]*Section 29.22(a)-15—Acquisition or Disposition by a Corporation of Its Own Capital Stock.*

"Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances."

. . .

"However, if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."

standard requisite of an examination of "the real nature of the transaction" in order to determine whether acquisition by a corporation of its own stock "gives rise to taxable gain or deductible loss."

It is respectfully suggested that the "real nature of the transaction" would be more readily discernible from an examination of the definition of "partial liquidation", as set forth in Section 115(i) of the Internal Revenue Code, supra. This appears to be of primary significance because if a transfer by a corporation of a substantial portion of its assets, by a bill of sale, to seven of its 134 shareholders in exchange for 8,000 of the 20,000 outstanding shares of capital stock, is a partial liquidation, as defined by statute, the other "facts and circumstances" can be of very little consequence. On the other hand, if the instant transaction is not within the scope of that definition, it cannot be other than a taxable exchange, within the purview of both Regulations 29.22(a)-15 and 29.22(a)-20, supra, as well as Section 111, Internal Revenue Code and its corresponding Regulation.[5]

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[5]*Section 111—Computation of Gain or Loss*

"The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . for determining gain, and the loss shall be the excess of the adjusted basis . . . over the amount realized."

Regulation 111, Section 29.111-1

"Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent."

The Tax Court apparently predicated its conclusion that this was a partial liquidation on the following observations:

(a) The minutes of the stockholders' meeting of June 7, 1951 (Exhibit 16) contained the words "proposed method of partial liquidation". These words were regarded as having "greater weight" than all of the other references to the corporation's plan to transfer assets for outstanding capital stock (R. 288-289).

(b) "The plan was not drawn in terms of purchase and sale, and no selling price of the assets was stated" (R. 288).

(c) Petitioner's directors adopted a resolution reducing the corporation's stated capital by the number of shares received in the transaction, which resolution was later ratified by the stockholders (R. 290).

(d) "Petitioner's business operations were substantially contracted" as a result of the transaction (R. 290-291).

None of the cases cited by the Tax Court and none of the cases examined by petitioner give judicial support to or approval of any of the above noted facts as being determinative or even influential in identifying a partial liquidation, as defined in the Internal Revenue Code (Section 115(i), supra). That statute is clear, succinct and specific in defining distributions by a corporation in partial liquidation to be for the exclusive purpose of "cancellation or redemption" of its stock. Accordingly, it would appear that a true partial liquidation would require the alteration or revision of the capital structure of the

corporation as the primary purpose for the distribution and the cancellation or retirement of the capital stock received thereby, to effectuate that purpose.

The substance of the transaction, not the form or the words used in connection therewith, determines the character of the exchange of corporate property for its own stock. *Allyne-Zerk Co. v. Commissioner,* (83 F.(2d) 525; *Commissioner v. S. A. Woods Machine Co.,* 57 F.(2d) 635; *Niagara Share Corporation,* 30 B.T.A. 668; *Spear & Co. v. Heiner,* 54 F.(2d) 134, 136.

Judicial examination of the substance of transactions that are similar to the one here in controversy has established strong precedent for the conclusion that petitioner was a party to a taxable exchange, rather than engaged in partial liquidation. In *Commissioner v. Boca Ciega Development Co.,* 66 F.(2d) 1004, the corporation exchanged a piece of its land for shares of its outstanding stock. In holding the gain to the corporation to be taxable income, the Court stated, in part, that ". . . the courts have held that a corporation acquiring its own stock may recognize a gain or a loss, provided the purpose of the transaction was not merely a capital readjustment".

In *Dorsey v. Commissioner,* 76 F.(2d) 339, the corporation sold the building that housed its plant and took a lease back. It received $100,000, represented by 1,000 shares of its own stock and $62,000 in money, as consideration for the transfer. After the transaction, the purchasers continued to hold considerable stock in the corporation. In the Court's opinion, the

value of the stock received must be included in computing gain or loss, the established principle being that when, in a business exchange, the transferor receives its own stock, it is converting by sale a previous purchase and if what it receives has a fair market value, the gain or loss realized in the exchange must be measured and taxed. In this connection the Court commented that "It is not the purchase of the stock but the sale of the real estate that is regarded."

In *Hammond Iron Co. v. Commissioner,* 122 F.(2d) 4, the corporation, by resolution, authorized the president to purchase for a certain sum shares of its outstanding stock and to pay cash or other assets, or both, to acquire such stock. The corporation acquired the stock, as authorized, with assets having an adjusted cost in excess of the value of the stock received. The Commissioner denied the loss, declaring the transaction to be a partial liquidation and not a sale of corporate assets. The Court, citing the *Dorsey* case, supra, stated, "It does complete violation to the facts to treat the transaction as a partial liquidation with the payment of a liquidating dividend and the surrender of stock for cancellation. Such a position is wholly untenable in fact and in law, for no single element of a liquidating dividend is present. It was a transfer of assets in payment of stock. It was nothing more." Further, the Court observed that "It is a loss not on purchase of stock but on the sale of assets given for the stock."

In *Trinity Corporation v. Commissioner,* 127 F.(2d) 604, the corporation exchanged its principal asset for

other real estate and its own stock. On the question of whether the value of the corporation's own stock, received by the corporation in the transaction, should be considered in determining its gain or loss, the Court, also citing the *Dorsey* case, supra, made this comment: "This Court has held that the *receipt by a corporation of its own stock and other property in exchange for its real property is a conversion, by sale, of a previous purchase;* that gain or loss resulting from such sale of corporate property for its own stock is realizable" . . . under existing laws and regulations.

In *Spear & Co. v. Heiner,* supra, the corporation owned five furniture stores. It sold one of them to one of its stockholders and accepted payment therefor in shares of capital stock. The adjusted costs of the assets transferred were in excess of the value of the stock received and the corporation claimed a loss on the transaction. The Court held that a deduction was allowable, as the transaction was a sale, the consideration being the seller's own stock.

See also, *Johnson McReynolds Chevrolet Co.,* 27 T. C. 300, 303, and *Country Club Estates, Inc.,* 22 T. C. 1283, 1287, 1292-3.

The cases, in point, cited by the Tax Court (R. 288, 290, 292) also corroborate the principle that a distribution in partial liquidation must be for the purpose of a capital adjustment in which cancellation or retirement of the corporation's stock is an essential element.[6]

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[6]These cases are briefed in Appendix "B" hereof.

In this case, the facts and circumstances clearly demonstrate that the sole motive, purpose and objective of petitioner was to alienate its hardware inventory and related property in the best transaction that could be arranged. Under the plan that was finally adopted, after consideration of other plans, petitioner executed and delivered a bill of sale to a partnership comprised of those stockholders who had accepted petitioner's offer to exchange property for stock. Both the partnership agreement and the bill of sale recited a valid consideration, the dollar value of which was known and easily ascertainable by the parties.

When petitioner received the 8,000 shares of its stock as consideration for the conveyance of corporation property, the stock was not cancelled or retired. Reduction of stated capital by resolution of the Board of Directors, ratified by stockholders, did not involve or require cancellation or retirement of stock as a result or prerequsite. The resolution was made in recognition of the reduction in outstanding shares and the effect thereof was to restore the shares acquired by the corporation to the status of authorized but unissued shares.[7] Thus, the financial structure of

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[7] *California Corporations Code*

"1700. A Corporation may redeem any or all shares which are redeemable at its option by (a) giving notice of redemption, and (b) payment or deposit of the redemption price of the shares as provided in its articles . . ."

"1706. A Corporation may *purchase,* out of stated capital or out of any surplus, shares issued by it, . . . in any of the following cases:

(a) To collect or compromise in good faith a debt, claim, or controversy with any shareholder.

the corporation was unaffected by the receipt of its stock. Also, under California law, petitioner's outstanding stock, being capital stock authorized by its Articles of Incorporation, was not subject to redemption, within the purview of Sections 1700 and 1706 of the California Corporations Code. (See footnote 7, supra.)

There appears to be no judicial authority for the finding by the Tax Court that the contraction of petitioner's business operations, resulting from its exchange of property for stock, was indicative of partial liquidation. The only case cited in support of this conclusion was *Pacific Vegetable Oil Corp. v. Commissioner,* 251 F.(2d) 682. (R. 290-291.) In that case, this Court reversed the Tax Court, holding that petitioner, a stockholder in another corporation, had received a dividend under Section 115(g), from the other corporation which had redeemed petitioner's stock. The Tax Court had previously decided that the distribution to petitioner had been in partial liquida-

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(b) To eliminate fractional shares.

(c) To redeem or purchase shares subject to redemption at prices not exceeding the redemption price thereof.

(d) From any shareholder who by reason of dissent from any proposed corporate action is entitled . . . to be paid the fair market value of his shares.

(e) From one who as an employee other than as an officer or director has purchased the shares from the corporation under an agreement reserving to the corporation the option to repurchase the shares."

"1710. When a corporation acquires its shares out of stated capital, under Section 1706, such shares are restricted to the status of authorized but unissued shares, and the stated capital may be reduced by resolution of the Board of Directors by the amount of stated capital attributable to such shares."

"1904. A reduction of stated capital may be authorized by a resolution of the Board of Directors approved by the future or written consent of the holders of a majority of outstanding shares . . ."

tion. As one of eight reasons for holding the distribution to be a dividend, this Court stated that "the purchasing corporation had adopted no plan or policy of contraction of its business".

On the other hand, in cases involving judicial consideration of the tax consequences to a corporation that acquired its own stock in an exchange, the financial or economic results of the transaction appear to be of no significance. In the *Allyne-Zerk Co.* case, supra, the corporation conveyed all of its property in exchange for its stock and cash. Similarly, in the *Trinity Corporation* case, supra, the corporation transferred its principal asset for its own stock and other property. Also, in the *Dorsey* case, supra, the corporation exchanged the building in which the corporation's business was located.

A careful examination of a number of cases of similar character has failed to disclose any instance in which judicial recognition of a business contraction or termination as the result of the acquisition by a corporation of its own stock has been at all persuasive in resolving the tax question involved. This so-called "business contraction" or "net effect" test appears to apply only to situations in which the legal question is (1) an individual's right to carry over a net operating loss, under Section 122(d)5, or (2) the tax status of a stockholder who has received a distribution that may be "substantially equivalent to a dividend", under Section 115(g).

The Tax Court's reference to petitioner's failure to comply with the Bulk Sales Law of California

appears to be of doubtful relevance to any issue in this case. (R. 289-290.) However, it may be observed that this statute is for the exclusive benefit of and available only to creditors who are prejudiced by a debtor's alienation of a large portion of his assets and does not prevent or invalidate a sale or transfer as between vendor and vendee or transferor and transferee. *Jeffrey v. Volberg,* 159 C.A.(2d) 815, 324 P.(2d) 964.

It is respectfully submitted that petitioner engaged in a taxable exchange in which the loss sustained may be recognized for income tax purposes, and did not, therefore, make a mere distribution of assets for the purpose of cancelling or redeeming its stock.

SECOND SPECIFICATION OF ERROR—THE TAX COURT ERRED IN HOLDING THAT IF IT BE ASSUMED, ARGUENDO, THE AFORESAID TRANSACTION WAS A SALE, THE LOSS RESULTING THEREFROM WOULD NOT BE A CARRYOVER NET OPERATING LOSS.

In connection with petitioner's reported deductions in its income tax returns for 1952 and 1953, as a carryover of the unused net loss sustained in 1951, the Tax Court ruled that, even if such loss were recognized, the right to the carryover would not be available to petitioner in succeeding years, under Section 122(a).[8] The basis for this conclusion is a finding by

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[8]*Section 122(a). Definition of Net Operating Loss.*

As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

the Tax Court that the loss carryover may be utilized only by a taxpayer who continues in the same business during the years following the loss and that ''substantial reduction'' or termination of a business by reason of the loss transaction would forfeit the carryover privilege.

Section 122(a) qualifies its definition of net operating loss with ''exceptions, additions and limitations provided in subsection (d)''. The paragraph in that subsection that is pertinent here is Section 122(d)-5[9] which imposes restrictions on computation and carryover of ''non-business'' losses. This statute specifically exempts corporations. However, prior to 1954, it would prevent individuals from carrying over excess losses from sales or exchanges of property to a ''substantially reduced'' or unrelated business activity in a subsequent year.

In each of the cases cited by the Tax Court in support of this ruling (R. 281, 286), except the *Lisbon Shops v. Koehler* case which is not in point because it involved a reorganization, it was an individual and not a corporation taxpayer who was denied a carryover of a loss incurred in a transaction that substantially changed or reduced the character and scope of the business or was unrelated to the taxpayer's principal business activities in the later years.

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[9]*Section 122(d)-5.*
Deductions otherwise allowed by law not attributable to operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of gross income not derived from such trade or business.

The Senate Finance Committee recognized this distinction between corporations and individuals when considering the intended effect of a revised statute covering net operating loss deductions (Section 172 of the 1954 code) and in its Committee Report on this proposed new legislation, made the following comments (pp. 212, 213):

> "A further substantive change will permit taxpayers other than corporations who sell a business or certain business assets in effect to include any loss sustained on the sale of such business or business assets as part of a net operating loss for the year of the sale. (Corporations are entitled to this treatment under present law and under this section.) Thus, subsection (d)(4)(A) will overrule the decision in Joseph Sic v. Commissioner (10 T.C. 1096, 177 F. (2d) 649 (CA-8) certiorari denied, 339 U. S. 913), and similar cases, which held, for example, that a farmer who sold his farm at a loss could not include such loss as part of his net operating loss. The cases indicated that such loss was a nonbusiness loss since the taxpayer was not in the business of selling farms. The new provisions will reach the opposite result."

The right of corporations to carry over (and carry back) losses sustained through sales of business assets, whether or not such sales were made in liquidation, is so well established, by reason of the unquestionable wording of the applicable statutes (122(a) and 122(d)-5), supra, that there are few cases in which the exercise of such right was in controversy.

The *Acampo Winery and Distilleries, Inc.* case, 7 T.C. 629, 639, gave the Tax Court an opportunity to decide on the extent to which a corporation may utilize these statutes in its deductions of business losses. Though the facts are distinguishable from those in this case, the principle involved is the same. The Winery corporation sold substantially all of its inventories and related properties to trustees representing its stockholders. Thereafter, for two years, the corporation continued in business pursuant to a plan of dissolution. During these two years, the Winery incurred losses which it carried back to the year of the sale, to reduce the taxable gain that was reported.

The Commissioner disallowed the carryback loss deduction, alleging that the corporation was "substantially liquidated and marking time" during the two years subsequent to the sale and "was no more the taxpayer it was in previous years, in substance and in fact, than if it had legally changed its existence". The Commissioner also contended that Congress intended to accord this deduction "only where the same taxpayer was continuing to carry on substantially the same business in the loss years that it carried on in the taxable year".

The Tax Court held that the deduction should have been allowed, stating: "The words in the statute are general in their application and something would have to be read into them that is not there to limit them so that they would not apply in this case". See, also: *Diamond A. Cattle Co. v. Commissioner,* 233 F.(2d)

739 and *Oahu Beach & Country Homes, Ltd. v. Commissioner,* 17 T.C. 1472, 1479.

The opinion of the Tax Court contains considerable discussion of the technique employed by petitioner's accountant in reporting the income tax consequences of the transaction at issue in this case. (R. 281, 284.) This accountant has been in active practice since 1919. (R. 133.) When he prepared petitioner's 1951 income tax return, he faithfully transcribed therein all the information contained in petitioner's books and records, bearing upon its income tax liabilities. The exchange of corporation inventory for stock and the corresponding reduction of stated capital in recognition of the diminished number of shares outstanding after the transaction were correctly reproduced in the fiscal statistics reported for tax purposes.

In keeping with petitioner's contention that this transaction was a taxable sale or exchange, it would appear that the method of revealing the tax results thereof would be significant only if there appeared to be an erroneous computation of tax liability.

Petitioner's income tax return disclosed its hardware inventory, on June 30, 1951, as zero. The Commissioner determining the inventory on that date to be $283,298.88 and then used that figure in computing petitioner's cost of goods sold. The income tax return of the partnership that acquired the property from petitioner reported the same amount as its opening inventory. Thus, the financial and tax consequences of the exchange were completely ignored.

The opinion did not declare that petitioner's method of computing the tax was wrong, and it is not clear as to what bearing, if any, the Tax Court's comments on the accountant's theory of reporting income had upon the insertion of a closing inventory figure for June 30, 1951. The Commissioner used that figure to give effect to his conclusion that the transfer of corporation assets was a partial liquidation, not because the accountant failed to perform his duties correctly.

THIRD SPECIFICATION OF ERROR—THE TAX COURT ERRED IN HOLDING THAT THE LEGAL, ACCOUNTING AND ESCROW EXPENSES WERE NON-DEDUCTIBLE CAPITAL EXPENSES.

The available evidence clearly and completely discloses the nature and extent of the legal, accounting and escrow services rendered in connection with all phases of the transaction whereby petitioner transferred assets in exchange for stock. These services were obviously essential to the accomplishment of a plan that was directly related to the conduct of petitioner's business.

The Internal Revenue Code and the Regulations grant permission, in simple and unequivocal language, to deduct "trade or business expenses" from gross income in computing net taxable income.[10] The Tax

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[10]*Section 23 I.R.C. Deductions from Gross Income*
In computing net income there shall be allowed as deductions:
(a) Expenses.
(1) Trade or business expenses
(A.) "In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a

Court held these expenditures to be capital contributions to the change in capital structure that resulted from partial liquidation. The disallowance of the deductions claimed by petitioner as to these items would, therefore, appear to be the proper consequence to the judicial conclusion that petitioner distributed assets in partial liquidation, as defined by the Internal Revenue Code (Section 115(i), supra). To hold otherwise would create an obvious inconsistency. However, petitioner contends that allowance of these deductions is a matter of law, as well as being equally consistent with the recognition of petitioner's transfer of assets for stock as a taxable exchange.

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reasonable allowance for salaries or other compensation for personal services actually rendered; . . ."

Regulation 111, Section 29.23(a)-1. Business Expenses.

"Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. . . . The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business."

CONCLUSION

It is respectfully submitted that the Tax Court was in error in the specifications set forth and judgment should be rendered in favor of petitioner.

Dated, San Mateo, California,
September 18, 1961.

Respectfully submitted,
RALPH A. YEO,
Attorney for Petitioner.

(Appendices A and B Follow)

Appendices A and B.

Appendix A

TABLE SHOWING ADMISSION OF EXHIBITS

Exhibit	Identified Record Page Number	Offered and Received in Evidence Record Page Number
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Appendix B

CASES CITED BY THE TAX COURT BEARING UPON ITS CONCLUSIONS RE: TRANSFER OF CORPORATION ASSETS FOR ITS OWN STOCK

R. 288—*Lencard Corporation,* 47 B.T.A. 58

Petitioner-Corporation redeemed all outstanding preferred shares held by one stockholder for shares of another corporation held by Petitioner-Corporation, pursuant to a resolution of Petitioner-Corporation:

> "Resolved, that all the outstanding preferred stock of this Company be redeemed and cancelled."

When the shares of its own stock were received by Petitioner-Corporation, they were immediately retired and cancelled, resulting in no preferred stock thereafter in existence.

Appropriate action was also taken to that effect by Petitioner-Corporation by filing a "Certificate of Retirement of Preferred Stock Redeemed Out of Capital" with the Secretary of State of Delaware.

Held:

> Transaction was partial liquidation because none of the essentials of a sale were present. *Considering the real nature of the transaction and the fact that the Corporation cancelled and retired the stock* acquired, rendered the action of the Corporation a true liquidation.

R. 288—*Commissioner v. Bedford's Estate,* 325 U. S. 283

Question was whether an exchange of stock held by a shareholder for other stock and cash, in a reorgani-

zation of the corporation, was a dividend to the shareholder, to the extent of the cash received. The basic question involved Sec. 112, I.R.C., which is not applicable to any question before the Court in this case.

The only reference to Section 115(i) (definition of partial liquidation) was at pages 291 and 292, where the Supreme Court stated, in holding said Section 115(i) inapplicable:

> "The definition of a 'partial liquidation' is specifically limited to use in Section 115. To attempt to carry it over to Section 112 would distort its purpose."

Held:

> Recapitalization under reorganization of a corporation does not alter the effect of a distribution out of earnings and profits as income to the shareholder to the extent of cash received in an otherwise tax free exchange.

R. 288-289—*C. M. Menzies, Inc.,* 34 B.T.A. 163, 164

Petitioner-Corporation transferred *all of its assets* to a stockholder who owned 90% of the outstanding stock, for approximately $87,000.00, the Petitioner-Corporation taking the stockholder's note therefor. The Petitioner-Corporation's tax returns for the year of the sale (1931) had a balance sheet attached thereto showing no corporate assets or liabilities. Also attached to the return was a notation to the effect that all assets and liabilities of the Petitioner-Corporation had been purchased and/or assumed by the individual stockholder, as of July 1, 1931; that this transaction had been without profit or loss; and that the Petition-

er-Corporation "was abandoned after said disposal of net assets".

The only issue was whether the transaction was a sale or distribution in liquidation.

Held:

The transfer was a sale. The facts show a purchase of corporation assets for cash or note. There was no exchange or surrender of stock which presumably continued to be outstanding in possession of the purchaser.

This case not in point, except to illustrate a pure sale for a stated amount, as compared to an exchange, where no dollar amount was stated, but with the consideration clearly described and valuations readily determinable.

R. 290-291—*Pacific Vegetable Oil Corp. v. Commissioner,* 251 F. 2d 682 9th Circuit

Petitioner-Corporation owned stock in another corporation, and offered to sell the stock back to it for cash. The offer was accepted and the stock was redeemed out of earned surplus. Petitioner-Corporation reported the proceeds of sale as a dividend under Section 115(g), I.R.C., claiming the 85% exclusion privilege under Section 26(b), I.R.C. The Tax Court held in accordance with the contention of the Commissioner that the distribution was in partial liquidation, under Section 115(c).

Held:

Tax Court reversed. *The redemption of stock has the same effect as a distribution of a dividend* where (1) the offer is made by the stockholder;

(2) the redemption was made from earned surplus; (3) the purchasing corporation adopted *no plan or policy of contraction of its business;* (4) the initiative for the corporate distribution came from the stockholder for its own purpose; (5) the relative position of the principal stockholders of the distributing corporation remained the same after redemption; (6) the capitalization at the time of cancellation of the redeemed stock represented earnings, not capital paid in; and (7) the net effect of the actions taken by the redeeming corporation was to leave it in the same position, insofar as operational purposes were concerned, as before the sale. Also (8) that the principal effect was to eliminate certain stockholders.

R. 291—*Lucius Pitkin, Inc.,* 13 T. C. 547

One of three stockholders surrendered his stock to Petitioner-Corporation, and received therefor certain corporation assets having a value approximately equal to this stockholder's original capital investment. The stock was cancelled by Petitioner-Corporation, and thereafter new stock, in same amount as dividend, was issued to two remaining stockholders.

Held:

Partial liquidation. "(pp. 552, 553) The object (of the exchange) was to eliminate Tour (the departing shareholder) and his stock from the organization, . . . The cancellation of the stock complies with the definition of partial liquidation in Section 115(i), I.R.C., for therein we find that partial liquidation means distribution in complete cancellation of a part of the stock. Tour's stock was not only surrendered, but cancelled."

Petitioner-Corporation did not receive shares as consideration for property. *Its purpose in acquiring the stock was primarily to eliminate one shareholder.*

R. 292—*Brockman Oil Well Cementing Co.,* 2 T.C. 168

Petitioner-Corporation acquired 12½ shares of its capital stock from one stockholder in exchange for his ratable share of the Petitioner-Corporation's assets—for the *purpose of allowing the stockholder to sever all of his interest in the Petitioner-Corporation,* in accordance with his and other stockholders' wishes. Petitioner-Corporation held the redeemed shares and reissued them later. *Commissioner seeks to tax the gain to Petitioner-Corporation on the subsequent sale of the stock.*

Held:

Neither the acquisition nor the re-issue of the stock was taxable as dealing in its own shares as it would in shares of another. There was no purchase and sale of stock. The acquisition was to eliminate a stockholder by mutual agreement. The sale was to acquire additional capital.

R. 292—*Hill v. Commissioner,* 126 F. 2d 570

Stock purchased for *express purpose of cancellation.* Therefore, partial liquidation occurred.

R. 292—*Oscar G. Joseph,* 32 B.T.A. 1192

Not in point. Involves tax liability of an individual who acquired cash and notes as a stockholder of a corporation that had previously sold its assets in partial liquidation.

R. 292—*Salt Lake Hardware Co.,* 27 B.T.A. 482, 486

Petitioner was a corporation (A) that owned stock in another corporation (B). Corporation B redeemed its stock from Petitioner-Corporation A in two installments, covering two successive years, and thereupon retired the stock so redeemed. Petitioner-Corporation contended that the money received for the stock was essentially equivalent to a dividend and, therefore, not taxable income because of the statutory exemption as to dividends received by one corporation from another.

Held:

The distribution was in partial liquidation. Petitioner-Corporation argued that there was never any intent to liquidate and that redemption of the stock could not be considered as a partial liquidation. In commenting on that contention, the B.T.A. stated (p. 486): "That argument can have persuasive force only by using the *word 'liquidation'* in the sense of winding up the affairs of the company. Admittedly that is the usual meaning of the word. *But here we cannot ignore the fact that Congress has established a different meaning for income tax purposes.* As set forth in the statute, ... a partial liquidation takes place whenever a corporation distributes money or assets in complete cancellation or redemption of part of its capital stock".

R. 292—*Dill Manufacturing Co.,* 39 B.T.A. 1023

Petitioner was a corporation that *purchased and cancelled outstanding stock* from a syndicate of minority stockholders *to quiet dissension* that existed

between them and the majority stockholders. Payment was made in U. S. bonds, owned by Petitioner-Corporation, and a small amount of cash. At the time the bonds were transferred, they had a market value of less than cost. Petitioner-Corporation claimed a loss on the transaction. The Commissioner disallowed the deduction on the ground that the transfer was a non-taxable distribution in partial liquidation.

Held:

There was a partial liquidation, despite Petitioner-Corporation's lack of intent to liquidate. In this respect, the B.T.A. stated (p. 1030): "However, absence of intent does not contradict the statutory status of a liquidation if, in fact, a liquidation occurred, by the cancellation or redemption of capital stock".

R. 292—*Johnson, Carvell & Murphy v. Riddell* (U.S.D.C., S. Dist of California), 173 F. Supp. 214

The Plaintiff, a corporation, exchanged some of its own property, consisting of stock in another corporation, for shares of its own outstanding stock and paid a tax on the capital gain derived thereby. Plaintiff then retired the shares so redeemed and sued for refund of tax paid, alleging that the transaction was a non-taxable distribution in partial liquidation.

Held:

Considering all the factors involved, the subject transaction was made in good faith and consisted of redemption in complete cancellation of the stock acquired, as provided in Section 115(i), I. R. C.